Turkey: Is deeper easing on the way?

We expect a 200bp cut on 25 July, though given increasing concerns about credibility, with the appointment of the new Governor, risks are to the downside. Remarks on economic activity and inflation, along with an emphasis on a reasonable rate of real return, the CBT is signalling deeper cuts until the year-end

CBT to begin easing in July

At the rate setting meeting on 25 July, we expect the Central Bank of Turkey to start an easing cycle and to come up with a 200bp rate cut given improvements in inflation and new Governor, Murat Uysal's remarks on 15 July. This is aligned with a Reuters survey (vs around 400bp priced in the market according to the swap curve), up from 100bp before the change in the CBT management.

"Room to manoeuvre" with improving inflation

In an interview, Governor Uysal supports this view as he sees "room for manoeuvre in monetary policy" on the back of:

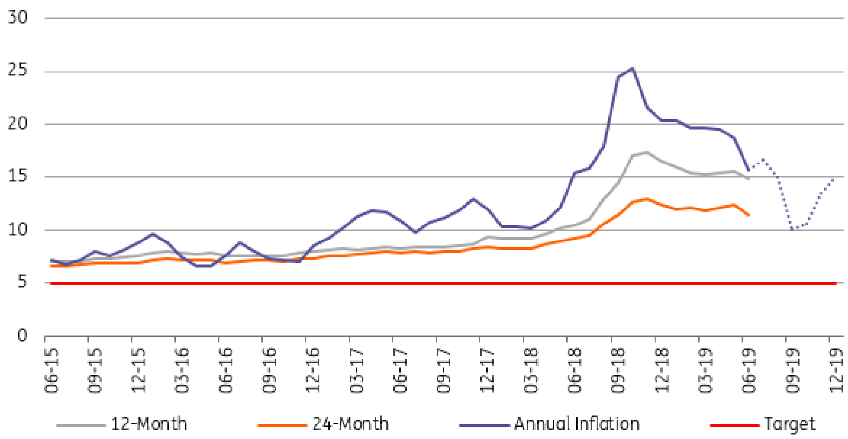
1. The downtrend in inflation: In fact, the most recent inflation data hints at improving price pressures with a downside surprise in recent months, reflecting the weakness in domestic demand and the CBT's tight policy, despite the volatile course of the exchange rate and still

high services inflation

2. Improving inflation expectations: The ongoing disinflation has also contributed to a recovery in inflation expectations given that according to the CBT's latest survey, 12M and 24M expectations have maintained a downtrend due to the backward-looking nature of expectations formation with the former down to 14.8% (from the highest since late 2003 at 17.4% in Nov-18) and latter to 11.5% (from 13%, an all-time high since the start of data collection in Mar-06).

So, in tandem with the expected fall in annual inflation, inflation expectations should recover further in the period ahead.

Inflation Expectations (%)



Source: TurkStat, ING Bank

The CBT to maintain "a reasonable rate of return"

The Governor also provides some further guidance regarding policy making that can be seen as evidence of a deeper than expected easing until the end of the year. In this regard he states that:

1) "The design of monetary policy will be based on a data-focused approach that takes into account all macroeconomic indicators, primarily inflation and economic activity.":

The Turkish economy remained on a rebalancing track in 1Q, with ongoing weakness in domestic demand despite strong public consumption and contributions from exports. The recent early indicators give encouraging signals in June with improving consumer and business confidence indices, rising PMI to the highest level in a year, higher capacity utilisation rate etc.

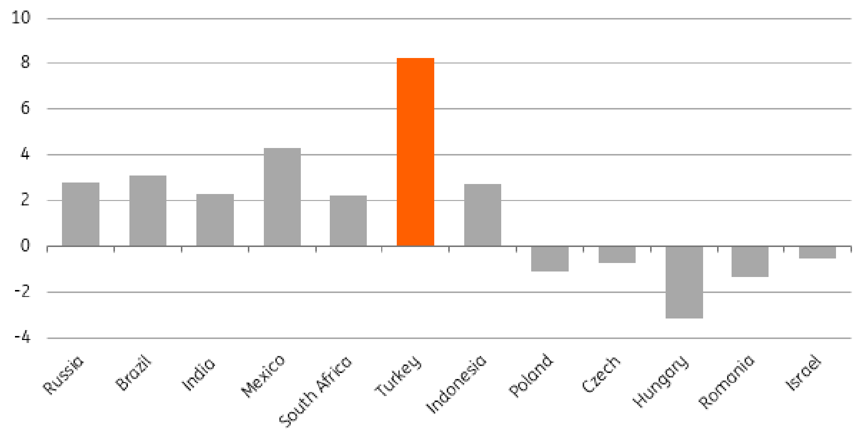
However, the recovery will be gradual and take time as the expanding budget deficit this year suggests that public consumption growth cannot be sustained, while loan growth has already lost some momentum. Given the focus on the activity along with a likely tightening in fiscal policy, the easing cycle in monetary policy may be larger to support the growth outlook.

2) "...(the CBT) will develop a framework that is built upon both expectations and our own projections and maintains a reasonable rate of real return.":

The ex-post real policy rate that had been low or sometimes even negative since the global crisis currently stands more than 800bp, above that of many emerging market peers. Sensitivity to shifts in global risk appetite, the still high-risk attitude towards Turkey due to geopolitical factors and lower credit ratings call for high real rates. Given the average ex-post policy rate for EM peers of around 300-400bp, and year-end inflation forecast below 15.0%, there is room for the CBT to come up with deeper cuts if geopolitical risks are managed and prudent policies are introduced in the aftermath of local elections.

Current real policy rates in EMs (%)

(we use 3m Bubor as a policy rate for Hungary)



Source: Bloomberg, ING

Markets are pricing a large easing until year-end

So, we now see a cumulative 500bp in cuts by the end of this year, while markets are already pricing larger easing. On the flip side, reviving currency volatility impacting the disinflation trend would remain a key variable for the CBT in the policy implementation as stated by the Governor that “to achieve an ever-improving inflation outlook it is crucial to maintain a cautious monetary policy”.

Following a significant underperformance, TRY has been strengthening recently, though the recovery seems to be quite fragile. So, sensitivity of the TRY to geopolitical news flows and domestic issues keeps the CBT cautious and requires a well-calibrated monetary policy to avoid currency volatility.

> Overall, the CBT Governor’s remarks suggest that the CBT was encouraged by the down-side surprises in the recent inflation data, while the pace of disinflation provides confidence for the timing of the policy easing in July.
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> So, a better than expected inflation outlook, more accommodative policy signals from global central banks, TRY strengthening and the contribution of declining geopolitical risk anticipation are all likely to encourage the CBT to start the easing cycle this month. We expect a 200bp cut on 25 July, though given the market’s increasing concerns about credibility with the appointment of the new Governor, risks are to the downside. Also, remarks on economic activity and inflation along with an emphasis on “a reasonable rate of real return”, the bank is signalling deeper cuts until the end of the year.

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